Module VII: Investing in Bonds

Summary: *In this lesson we will discuss some of the aspects related to investing in bonds. We begin with a simple explanation of what a bond is and then review some terminology that will help you understand how bonds are priced. We will also discuss the types of bonds available to an individual and the importance of bond maturity depending on how long one keeps those bonds in his or her possession. Lastly, we will touch on ways to purchase bonds and give you some helpful websites that will provide more information on this subject matter. Let's get started!*

What Exactly Is A Bond?

A bond is a loan between you the investor and the issuer of the bond. Basically, you give the issuer your money for a specified time, and in return, the issuer agrees to make interest payments to you along the way to compensate you. Most bonds (all bonds issued by the Federal Government except Savings Bonds) are entered in book entry form. This means that the owner is registered in database, like most stock owners. Bond certificates can be issued but that will cost the purchaser more, just like stock certificates. When there were bearer bonds these were issued to the purchaser and a coupon was sent in for the interest payment. The purchaser had an interest-bearing certificate in his or her possession as proof of the transaction. These bonds are no longer issued.   At the end of the agreed upon period, the issuer agrees to return all of your money to you along with the remaining interest.

Understanding The Terms

1) Call Risk – this occurs when the bond issuer pays the face value of the bond before the maturity date in order to re-issue the loan at a lower interest rate.

2) Credit quality – the ability of the bond issuer to repay the principal or face value of the bond.

3) Credit risk – if the issuer defaults on the agreement, that is fails to make timely payments of principal and interest, you could lose all or some of your money.

4) Current income – the income you receive from the bond either monthly, quarterly, annually, etc.

5) Event risk – events in nature or the business environment, such as a storm or a merger can affect the value or credit worthiness of the issuer.

6) Inflation risk – the risk that inflation will affect the inherent value of your bond if the interest income you earn remained the same over the life of the bond.

7) Interest rate risk – bonds are locked in at a set rate upon issuance, changes in interest rate will affect the value of the bond, e.g if you lent company A $1000 at 6% interest for 5 years and the interest rate goes up to 8%, you would not feel as good about your 6% interest because the market is paying 2% more for the same bond you receive 6% interest on.

8) Issuer – the agency, corporation, state or local government entity offering the bonds.

9) Maturity – the date that the amount stated on the bond should be repaid to the bondholder.

10) Discount – when a bond sells for less than its face value.

Types Of Bonds

EE SAVINGS BONDS United States Savings Bonds are government-issued and government-backed. They are debt instruments that make periodic interest payments. These payments are added (accrue) to the value of the bond, rather than being paid in cash. You can purchase these bonds by having the money deducted from your pay. The purchase price for an EE Savings Bond is half the value of the bond. For example, if the bond's face value is $100, then you would pay $50 for the bond. The bond would then accrue interest every month until it reaches its face or maturity value. After 17 years, new EE Savings Bonds are assured of reaching their face value. A bond issued today could actually reach face value sooner depending on current interest rates.

SERIES I BONDS These savings bonds offer some measure of protection against inflation by having the monthly increase in value pegged in part to the Consumer Price Index for all urban consumers. If inflation rises, eroding the value of fixed investments, the bonds will increase in value to compensate. Series I Bonds yield a combination of two rates. One is a fixed rate of return (currently 3.00%). It applies to all Series I Bonds issued during a six-month period beginning May 1 or November 1. This rate remains the same for the life of those bonds. The second rate is the inflation component (currently 2.93%), which will be changed each May 1 and November 1 based on the average CPI-U (Urban Consumer Price Index) from the prior October through March or April through September. Added together, the two rates produce the total yield for the bond.

TREASURY BONDS (Treasuries) - are bonds issued by the Federal Government and are backed by the full faith of the US Government. These are by far the most secure bonds but generally carry the lowest interest. The interest rates are lower on these types of bonds due to the lower risk of default.

There are three basic types of treasury bonds:

Treasury Bills - mature in one year or less
Treasury Notes - mature within 1 to 10 years
Treasury Bonds - mature from 10 to 30 years

There are four basic advantages of buying treasury bonds:

1) Stability - because the US government is unlikely to default on its debt money is invested is guaranteed to be returned.
2) Liquidity - because of the high credit quality of treasury bonds they are easy to buy and sell on the open market.
3) Call Protection - treasury bonds are usually not callable so interest is guaranteed to maturity of the bond.
4) Tax Advantage - Income from treasuries is exempt from state and local taxes.

There are three basic disadvantages of treasuries:

1) Interest rate risk - bond values are affected by current interest rates. As rates go up, the value of bonds decline. This affects the amount you can sell your bonds for on the open market if you decide to sell the bond before it matures.
2) Less Current Income - because of the relative security of treasuries, the income paid is significantly less than can be earned from other forms of investments.
3) Inflation risk - the rate of inflation can erode the value of the return on your bonds.

AGENCY BONDS - These types of bonds are offered by government agencies and are about as safe as treasuries. You have probably heard the terms “Fannie Mae” and “Ginnie Mae.”

Government National Mortgage Association (GNMA, “Ginnie Mae”)
Federal National Mortgage Association (FNMA, “Fannie Mae”)
Federal Home Mortgage Loan Mortgage Corporation. (FHLMC)
Federal Home Loan Bank (FHLB). As the names imply, these bonds are associated with mortgage loans. The main advantage of these bonds is the security of principle or the amount you invested in the bond. Prepayment is a risk specific to this type of bond. This occurs when homeowners pay off their mortgages early, so the agency has to call the bonds.

MUNICIPAL BONDS – are long-term debts issued by local governments and their agencies. They can be either general obligation bonds or revenue bonds. Revenue bonds are bonds backed by the revenue from the projects built or maintained by the bond's proceeds. Revenue bonds typically have a higher yield because they have more risk than general obligation bonds. Because of their tax-free yields, this type of bond usually attracts the investors in the 28% or higher tax brackets. Shop around to keep the commission low since the price of commission is built into the total price of the bond.

GENERAL OBLIGATION BONDS – are issued to finance basic local government needs. Municipal bonds are generally exempt from federal taxes. They may also be exempt from state taxes if you live in the state issuing them. These bonds are backed by the “full faith and credit” of the issuer and are repaid with taxes assessed by the issuer.

CORPORATE BONDS - are issued by business corporations. The classification of these types of bonds is based on the credit rating of the bond. Most corporate bonds are assigned a letter coded rating by independent bond-rating agencies. Two agencies rate bonds: Standards and Poors, and Moody. Ratings range from AAA to C investment grade to what is often referred to as junk bonds or high yield bonds. Some benefits to corporate bonds is that they usually provide higher interest income than Treasuries and agency bonds because they are considered to be less safe than government securities, and the market rewards investors for assuming even a small amount of additional risk.

Ways To Purchase Bonds

You can purchase Treasury bonds directly through the Federal Reserve or through a bank. Corporate and municipals bonds are usually purchased through brokerage firms or bond dealers. Not all bonds are created equally.

Importance Of Bond Maturity

Generally the longer you hold a bond the greater the risk of losing value due to interest rate changes. Bonds are classified as:

Short term – one year or less
Medium term – one to five years
Long term – 10 to 20 years

The point is that the duration of a specific bond you are interested in, or the average duration of the bond fund, should be less than your specific investment time period. In other words, if you won't need your money for 6 years because your daughter just started middle school, then keep your duration of your fixed income investments less than 6 years.

Conclusion

Bonds can play a vital role in your portfolio. If you are young with a high tolerance for risk and have a long time horizon you may want to consider other types of investing products like index mutual funds or actively managed mutual funds as discussed in Module VI. But as you get older, you may want to start protecting some of your return by moving some of the money out of stock-related investments into bonds. As stated in previous modules, the risk of losing your original investment is much less when investing in bonds than in stocks.

Another good reason people invest in bonds is because they want to generate income from their portfolios to live on when they are older and retired. People are living longer and enjoying more years of retirement, so be careful to keep some money invested in stock-related products to protect yourself against inflation (rising prices). Always carefully balance the amount of risk you are willing to accept with your investments against the erosion of your purchasing power due to increasing prices. Lower risk investments do not always shield you against inflation due to their lower returns.

Recommended Websites

www.investinginbonds.com

www.tomorrowsmoney.org

www.bondconnect.com

www.bondresources.com

www.bondtalk.com

www.savingsbond.com

www.kiplinger.com

www.moneycentral.msn.com